LEGISLATIVE
OVERSIGHT
COMMITTEE

TIFA

TRANSPORTATION
INFRASTRUCTURE
FINANCING
ALTERNATIVES

MEETING AGENDA
JUNE 24, 2002
1:30-4:00 P.M.

1. Introductions and Meeting Overview	Rhonda Brooks, Program Manager Washington State DOT
2. Overview of Public-Private Partnerships and Tools for Innovative Financing	Geoff Yarema, Esq. Nossaman, Guthner, Knox & Elliott
3. BREAK	
4. Discussion of Draft Study Work Plan (GREEN)	All
5. Committee Administrative Issues Appoint Co-Chairs Meeting Schedule (BLUE) Suggested Travel Options (PINK) Draft Web Site	All
6. WRAP-UP	

Briefing Papers provided by Mr. Yarema
(Shades of YELLOW)

Washington State / Legislative Oversight Committee

on Public Private Partnerships

June 24, 2002

TRANSPORTATION PROJECT DELIVERY:

OPTIONS, PUBLIC-PRIVATE ROLES AND

SUITABILITY CRITERIA

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INTRODUCTION

Objective

This report discusses various project delivery mechanisms for transportation. By project delivery mechanisms we mean the type of relationship a procuring agency selects to form with the private sector that is best suited to meeting the goal of a project's needs and characteristics.

The report defines the terms to be used in the analysis, describes the key institutional features of the various options and reviews suitability criteria for each option.

Analytical Approach

The project delivery mechanisms outlined below follow a continuum from traditional public agency development, funding and operation at one end of the spectrum, to private design, construction and operation with no public subsidy at the other. Intermediate options include varying roles for the public and private participants in project definition, work responsibility, risk allocation and funding. Since the differences among the options are largely incremental, this report will first identify the basic features of traditional public agency project development, and then describe the fundamental differences in each successive option. The attributes of the various contract arrangements described below are necessarily generalized, and it should be recognized that variations are usually negotiated in actual project contracts.

Options Reviewed

This report reviews the project delivery mechanisms listed below. Each option has been utilized in providing various transportation systems in the United States and other countries. The goal is to identify their suitability for other projects. The options reviewed include:

1. Traditional public works development, funding and operation, in which a state or local government agency assumes the broadest role in planning, construction, financing and operation of a public works project, paying private companies largely on a pay-as-you-go basis to provide consultant, engineering and construction services for project elements.

2. Traditional public works development, funding and operation, modified to employ design-build contracts for one or more key project elements or segments, for which a private company provides final design

bundled together in one contract with construction and/or equipment supply and installation.

3. Design-build contracting for an entire project with public funding and operation.

4. Design-build contracting for an entire project with public operation and primarily public funding, but with the contractor providing limited cash-flow financing in the form of development cost advances, interim cash-flow financing and/or subordinated debt.

5. Design-build-operate-maintain contracting for an entire project with public funding, with the contractor providing long-term operation and maintenance services at predictable costs and the government sponsor retaining the operating revenue risk.

6. Design-build-operate-maintain contracting with primarily public funding and with the contractor providing limited cash-flow financing in the form of development advances, interim cash-flow financing and/or subordinated debt.

7. Design-build-operate-maintain contracting with private financing secured by the government agency's obligation to make scheduled payments under the contract.

8. A private concession to design, build, operate and finance the project, with the design-build-operator receiving an interest in the operating profits of the enterprise, and the government providing limited financial assistance, taking such forms as development period cost-sharing or limited revenue guarantees.

9. A private concession to design, build, operate and finance the project with no public subsidy or other government financial commitment.

I. TRADITIONAL PUBLIC WORKS DEVELOPMENT, FUNDING AND OPERATION

A. Public/Private Roles

Traditionally, federal, state and local governments in the United States have assumed a broad role in planning, construction, financing and operation of public works projects, largely funding projects on a "pay as you go" basis. The role of private companies has been generally limited to serving as

consultants to the agencies or acting as independent contractors to provide construction services, equipment and materials pursuant to low-bid contracts. This approach is sometimes referred to as "design-bid-build" procurement. In the traditional contract model, design and other professional services are contracted for separately from construction work.

1. Government Responsibilities and Risks

(a) Project Development. In most, but not all, of the project delivery mechanisms identified herein, a government agency typically assumes the lead in determining the need for a project and defining its scope. In the initial stages of a project, it will, through its own staff or consultants, undertake environmental permitting and impact reporting, and acquire necessary right-of-way and other real estate interests essential to the project. It will then undertake to design each of the project components (with its own staff, or with the assistance of private design engineering consultants) to the level required to prepare bid specifications for each component or element of the project. It then awards various contracts for construction, equipment and material supply pursuant to low bid procurement procedures, which are typically mandated by statute. A public agency generally relies on its designers to consider long term cost efficiency.

(b) Construction. The agency supervises construction with its own staff or a team of construction management consultants, who review the quality of construction work and conformance to the contract specifications. The agency is responsible for overall project integration and the enforcement of contractor warranties (which historically are rare in the United States). Because bid specifications must be narrowly drawn to permit competitive bidding, the agency typically assumes all risk of change orders required by reason of (a) design changes, (b) design defects, (c) differing site conditions, (d) changes in applicable laws and regulations, and (e) most force majeure events. As a result, the final cost of the project and completion date may vary significantly from the original projections.

(c) Financing. Major public works projects in the United States have traditionally been financed entirely with public funds, including (a) general fund appropriations; (b) dedicated tax revenues (such as sales and gas taxes); and (c) federal allocation from the highway trust fund. U.S. transportation agencies approach the use of debt financing in varying ways. Some maintain a strict "pay as you go' policy. Others supplement outlays of annually appropriated traditional state and federal gas tax and other vehicle use fees with borrowings against state and local tax revenue streams. Still others rely upon toll revenue bonds to supplement traditional transportation funding. A few states have begun to take advantage of a new ability to borrow against future allocations of federal gas tax

revenues, know as GARVEE. More and more, local jurisdictions are developing their own sources to fill project funding gaps. Such measures include local option sales taxes, benefit assessment districts and development fee programs, among many others.

(d) Operation and Maintenance. Until recently, most major public works in the United States have been operated and maintained by public employees. The government agency remains responsible for undertaking all repairs and renewals, which are funded from general fund appropriations, special taxes or, in certain cases, federal operating subsidies.

2. Private Sector Risks and Responsibilities

The private contractor is responsible to provide a scope of services for the price and in accordance with detailed specifications set forth in the bid documents (subject to change orders), and may be liable, depending upon contract provisions and applicable state law, for negligence and/or breach of warranty for a stated period following completion of the services. The contractor's obligations are usually secured by a performance and payment bond that protects the agency in the event of failure of the contractor.

B. Suitability Criteria

Traditional public works development funding and operation is most suitable for projects constructed by government agencies that are well-staffed and have proven competence in managing development, construction and operations of projects of comparable size and complexity.

"Design-bid-build" procurement is most successful in projects, such as highway construction, utilizing proven technologies with well-understood construction risks, and capable of being executed by more than a limited number of firms. Ample sources of public funding, not dependent on project revenues, are required to absorb the full range of project risks assumed by the public sector. Because the competitive bidding procedures require 100% design prior to commencement of construction, this method is best suited for projects not involving significant time constraints.

Competitive bidding, which is being used by government agencies throughout the United States, is designed to protect against favoritism and graft in government contracting; it does not necessarily provide the lowest ultimate project price. Agencies utilizing "design-bid-build" procurement must be successful in managing design consultants to prevent "over design" of the facility.

II. TRADITIONAL PUBLIC WORKS PROCUREMENT, MODIFIED TO EMPLOY DESIGN-BUILD CONTRACTS FOR ONE OR MORE KEY PROJECT ELEMENTS OR SEGMENTS

A. Public/Private Roles

In recent years, a number of large transportation agencies have modified their traditional procurement arrangements to utilize "design-build" contracts for portions of their transportation systems. The basic feature of design-build is the "bundling" of final design and construction services together into one contract. Since a single contractor or consortium is responsible for delivery of the entire project, this method is also sometimes referred to as "turnkey" construction.

1. Government Risks and Responsibilities

Where design-build contracting is incorporated into a larger project, the public agency generally retains responsibility for all development activities through the preliminary design stage. It then requests proposals from private sector firms to furnish final project design and construct the project in accordance with performance criteria rather than detailed design specifications. While some design-build contracts are awarded on a lowest responsible bidder basis, good procurement practice frequently favors the two step RFQ/RFP approach, where the agency pre-qualifies proposers and then evaluates proposals based not only on price, but on a range of other factors including (a) the Contractor's track record in similar engagements, (b) its technical expertise, (c) its contract management skills, (d) its financial strength, (e) the suitability and cost-effectiveness of the proposed design, (e) completion date guarantees, and (f) the type of risk the contractor is willing to assume without modifying the guaranteed contract price.

Because the contractor assumes design risk and responsibility, the agency's oversight is limited to assuring that the design and final construction meet the performance specifications set forth in the request for proposals. The agency remains responsible, however, for assuring integration of the design-build contract work with remaining system elements, and enforcing contract warranties and guarantees.

2. Private Sector Risks and Responsibilities

Under a design-build contract, the private contractor's responsibilities and risks are substantially expanded from those under traditional construction contracts. It is responsible for the final design of the project, and should be prepared to indemnify the agency against design defects (even if the

defect is inherent in the preliminary design furnished by the agency). The combination of design and construction responsibilities gives the contractor the flexibility to proceed with some construction activities prior to completion of all design elements, thus achieving significant time savings. Control over all project activities makes it possible for the contractor to guarantee a final completion date, subject only to force majeure events that are outside the contractor's control, cannot be covered by insurance or are due to agency fault or agency-caused delays. The price may be fixed, or there may be provisions for cost reimbursement up to a fixed ceiling. Although the contractor may retain more flexibility in subcontracting and materials acquisition, it will typically remain subject to the same non-discrimination, affirmative action and wage scale provisions as with traditional contracting.

Additionally, it has become typical for contracts to incorporate "value engineering" concepts in which the price may be adjusted downward based upon innovations that the contractor develops during the course of performance, with the contractor being entitled to a share of the cost savings.

B. Suitability Criteria

Utilization of design-build for project segments or components is suitable for agencies that have the capacity to do traditional procurement, but nevertheless need the advantages of design-build as a result of time or fiscal constraints. The agency is willing to cede detailed project control to a contractor to obtain price and completion guarantees and broader performance warranties.

The segment for which design-build contracts are used must be sufficiently discrete to avoid overlapping responsibilities. Preferably, the agency should have the legal authority to engage in competitive negotiation, though a "two-step" proposal and bid approach can be sometimes be utilized. Such legal authority is increasingly found, but is far from ubiquitous.

Because design-build involves construction of an entire project segment under a single contract, the agency should have identified and secured all necessary contract funding prior to letting of the contract for the project or any discrete phase of the project.

III. DESIGN-BUILD CONTRACTING OF ENTIRE PROJECT WITH PUBLIC FUNDING AND OPERATION

A. Public/Private Roles

The benefits of design-build become especially important for construction of entirely new projects by sponsoring agencies which lack large development and construction management staffs, and which face significant financial and time constraints.

1. Government Risks and Responsibilities

The agency's role in the design-build procurement of an entire project is the same as described in Section II.A.1 above. Since the contractor has responsibility for the entire project, however, the agency may be able to shift to the contractor responsibilities (and the attendant risks) relating to determination of site conditions, right-of-way review and acquisition, identification of utilities requiring relocation, interface with utility owners, local permitting and/or project and systems integration. Although the agency must still define the project, carry out preliminary design and engineering and develop performance specifications, it may chose to utilize private consulting firms rather than building up a large in-house engineering staff.

Since the agency will be responsible for operation, its operating staff should provide input to the contractor during the design and construction phase.

2. Private Sector Risks and Responsibilities

Under this scenario, the contractor's responsibilities extend to providing design and construction for the entire project, including all project and systems integration. Because the contractor is responsible for the entire project, it is freed from the necessity to conform to certain specifications required to insure smooth integration with other project elements. It can be expected to provide warranties extending for some period into the operations phase. Although it may agree to pay liquidated damages in the event of a delay in completion (or receive an early completion bonus), it does not necessarily assume any financing risk with respect to the project.

B. Suitability Criteria

Design-build procurement for an entire project with public funding and operation is especially suitable for publicly funded projects undertaken by

agencies that are unable or desire not to develop in-house design and construction management resources, and otherwise have not completed final design or awarded project construction contracts. Nevertheless, public sources of funding for construction and payment of operating expenses are identified and secured in advance of commencement of construction. The agency must have the initial resources to conduct preliminary engineering, site acquisition and environmental permitting. Since it will retain operating responsibilities, it must develop its own operating and maintenance staff, utilize that of another agency or separately contract for operations.

IV. DESIGN-BUILD CONTRACTING FOR AN ENTIRE PROJECT WITH PUBLIC OPERATION AND PRIMARILY PUBLIC FUNDING BUT WITH THE CONTRACTOR PROVIDING LIMITED CASH-FLOW FINANCING

A. Public/Private Roles

For the opportunity to contract for multi-million or multi-hundred million dollar projects, private consortia have shown willingness to provide in appropriate circumstances some limited financial assistance to bridge critical gaps in the timing or availability of project funding.

1. Government Risks and Responsibilities

Even though a design-build project is to be financed primarily and ultimately with public sources, the contractors on large contracts may have the resources to help overcome certain financial obstacles, particularly those related to the timing of receipt of public funds, or the financial risks associated with cost over-runs due to project delays and change orders. The general funding risk remains with the agency. Because the agency, rather than the contractor, is responsible for operations of the project, the contractor's financial exposure usually does not encompass operating revenue risk.

2. Private Sector Risks and Responsibilities

The Contractor may (a) advance development costs, (b) provide cash flow financing of construction costs, and/or (c) provide a portion of the permanent financing in the form of subordinated debt.

(a) Development Cost Advances. In advancing development costs prior to the closing of financing, the contractor can help reduce the total cost of the project by reducing the length of the construction period. Unless the agency guarantees that such costs will be reimbursed even if the project does not go forward, the contractor assumes the risk that environmental permits may be delayed or never received or that final project funding will be withdrawn or prove infeasible. For

assuming such risks, the contractor and agency may negotiate a suitable premium to be paid to the contractor upon financing. While there are instances of such private funding in U.S. transportation projects, they are quite limited to date.

(b) Cash Flow Financing. If public funding is to be made available over a period of years from grant proceeds or appropriations, but the agency lacks the ability to issue debt secured by such future revenues, a contractor may be willing to accept a delayed payment schedule. Its construction price will then include its own cost of financing. If the deferred payments are "subject to appropriation", the contractor or its own lenders may or may not require some form of additional security, such as a security interest in the project, depending upon underwriting considerations.

(c) Subordinated Debt. If construction is to be debt financed by the agency, but project revenues are insufficient to provide the high coverage ratios required for 100% senior debt financing, the contractor may be willing to receive a portion of its compensation (generally not in excess of its profit) in the form of subordinated debentures. It may also be willing to share with the agency some of the risk of cost over-runs or delays by agreeing to accept subdebt as payment for change orders.

B. Suitability Criteria

To induce contractors to advance development financing, the prospect of reaching full financial closing must not be subject to great uncertainties, and ultimate project financial viability must be assured. Alternatively, the government must have the ability to repay development advances in the event the project does not proceed.

For interim construction financing, sources of funding of future payments must be assured; if such future payments are "subject to appropriation", the contractor will probably require some form of security interest in the project.

Contractor subordinated debt can provide a critical part of the financial structure, while adding to contractor incentives to deliver on-time and under-budget. Project revenues also must be sufficient to absorb the higher cost of subordinated debt necessary to compensate the contractor for its financing costs and assume the additional risk of payment.

V. DESIGN-BUILD-OPERATE-MAINTAIN CONTRACTING FOR AN ENTIRE PROJECT WITH PUBLIC FUNDING

A. Public/Private Roles

Design-build contracts can be structured to provide for contractor operation and maintenance ("O&M") of the facility it completes. Under the design-build-operate-maintain contract discussed in this Section (and in Sections VI and VII), the contractor provides operating and maintenance services, with the agency retaining operating revenue risk. These contracts are sometimes referred to as "DBOM" contracts.

1. Government Risks and Responsibilities

The agency, in addition to drafting system performance specifications, will detail in the contract operating and maintenance specifications for the term of the operating agreement. Because the contractor is taking the risk that the system will perform as required for the term of the operating period, the agency may not need to require as high a level of design review as it would if it assumed all operating responsibilities.

During the operations phase, the agency will supervise the operator with agency management personnel or consultants, and will have the ability to terminate the contractor.

The agency will retain responsibility for fare or toll-setting and the determination of service levels. As a result, the agency retains operating revenue risk.

2. Private Sector Risks and Responsibilities

The contractor undertakes to provide all operations and maintenance services with its own personnel for the term of the operating agreement in return for a fixed fee, subject to escalation for economic factors and changes in required service levels. By committing to a fixed fee for O & M, it essentially provides to the agency a long-term warranty on its design and construction work. To protect against a contractor "low-balling" the operating cost, the contractor may be liable to the agency, in the event the operating contract is terminated due to contractor default, for the additional costs the agency would incur over the life of the contract in providing the services itself or through a substitute private operator.

Because the contractor is taking both construction and O&M risk, the contractor has a special incentive to perform rigorous value engineering and analysis of the project's "life cycle costs."

B. Suitability Criteria

Extending the contract to cover operations is particularly suitable where the system's technology is sufficiently advanced or unique that a long-term operations warranty is desirable.

The agency must not be restricted from contracting-out operations under applicable laws or collective bargaining agreements. The agency must have sophistication in life cycle costing in order to assess the relative competitiveness of the contractor's operating fee.

If construction is to be financed with tax-exempt bonds, the contract must be structured within IRS management contract requirements that may limit the term or the form or amount of incentive payments (for a summary of these important rules, see Attachment A).

The consortia members must include a company with suitable operational experience, and all consortia members must be willing to share the operations risk. However, operating revenues typically will not be sufficient to shift the revenue risk and the attendant rate setting responsibility to the contractor.

VI. DESIGN-BUILD-OPERATE-MAINTAIN CONTRACTING WITH PRIMARILY PUBLIC FUNDING, BUT WITH CONTRACTOR PROVIDING LIMITED CASH FLOW FINANCING

A. Public/Private Roles

As with the design-build contract arrangement, a design-build-operate-maintain contract can include various forms of contractor cash/flow financing as described in Section V, above. Because the contractor is in the deal for the "long haul", it may have a greater incentive to participate financially, though its lack of control over operating levels and fare or toll-setting will limit its willingness to assume project revenue risk.

1. Government Risks and Responsibilities

See Section V.A.1, above for discussion of government risks and responsibilities under design-build-operate-maintain contracts.

2. Private Sector Risks and Responsibilities

See Section IV.A.2, above with respect to contractor providing development, cash flow or subordinated debt financing.

B. Suitability Criteria

See discussion in Sections IV (with respect to contractor financing) and V (with respect to design-build-operate-maintain contracting).

VII. DESIGN-BUILD-OPERATE-MAINTAIN CONTRACTING WITH PRIVATE SECTOR FINANCING

A. Public/Private Roles

For certain types of facilities, the private contractor can contract to build, own or lease and operate a facility, and finance it privately, based on payments to be contractually agreed to by a government agency. As opposed to the concession arrangements, described in VIII and IX, below, the contractor does not provide a retail service or otherwise set the rates to the public.

1. Government Risks and Responsibilities

The agency's responsibilities are as described in Section V above, except that it does not have to provide construction financing. It must, however, have the authority to enter into a long-term service contract, with a source of ongoing revenues to support its payment obligations, such as general tax or system revenues.

2. Private Sector Risks and Responsibilities

The Contractor's risks and responsibilities are the same as in Section V above, except that it must be willing to accept the long-term credit risk of the agency. The Contractor's lenders will not only be looking at the Contractor's ability to perform, but also the agency's ability to pay.

B. Suitability Criteria

For private financing to be feasible for a design-build-operate-maintain contract (not involving an operating concession), the agency must be willing to limit its right to terminate the O&M portion of the contract for reasons of contractor default. If it desires to terminate the contract "for convenience," it must

be able to compensate the contractor for its unrecovered capital investment in the facilities.

The agency's general credit must be financeable, because the contractor (and its lenders) are taking its long-term credit risk.

VIII. PRIVATE CONCESSION TO DESIGN, BUILD AND OPERATE THE PROJECT WITH DESIGN-BUILD-OPERATOR RECEIVING AN INTEREST IN THE OPERATING PROFITS

A. Public/Private Roles

Under concession, sometimes referred to as franchise, arrangements the government grants the private contractor a franchise to build, own (or lease) and operate the project with a right to determine rates generally and to receive all or a portion of project revenues. The government may contribute modest or even significant funding for design, permitting and capital costs.

1. Government Risks and Responsibilities

The agency can award a concession for a project it conceives or conceived by the private sector. A select few states have the legal authority to accept unsolicited proposals; a few others may award concessions based upon a request for proposals. In either event, the agency evaluates proposals based on the independent merit of the submitted project concepts against predetermined criteria, as well as the proposer's technical, management and financial strength.

The agency negotiates with the selected proposer exclusive development and operating rights for a stated term of years. The agreement may include a promise by the agency not to construct or permit the construction of competing facilities. The agency may retain ownership of the facility or the real property on which it is constructed with a lease back to the developer, or it may transfer ownership to the developer with a reversion back to the government after the concession terminates. Issues of property tax, tort liability and hazardous materials cleanup exposure tend to favor government ownership in many cases.

The franchise arrangements will deal with limitations on toll or rate setting by the franchisee or will indirectly limit rates by setting a ceiling on the franchisee's return on its investment.

The agency will usually retain the right to terminate the concession if the contractor fails to proceed to develop and finance the project in accordance

with predetermined performance milestone schedules. The agency will provide, directly or indirectly, general oversight of design construction and operation to insure that the contractor complies with the terms of the concession agreement, applicable State standards and other legal requirements.

In light of the agency's reversionary interest in the project and/or project financial feasibility, the agency may participate financially in a concession by (a) acquiring or assisting in the acquisition of the right-of-way, (b) assuming responsibility or otherwise assisting in the obtaining of environmental clearances, and/or (c) providing supplemental revenues or revenue deficiency guarantees. In some instances, these costs may be repaid from the proceeds of the project's financing.

2. Private Sector Risks and Responsibilities

The prospective franchisee will initially define the project or select a project offered by the government based on its own determination of project feasibility, assuming the role of project proponent. Typically, the contractor will assume responsibility for conducting the economic and traffic or ridership studies necessary to convince investors and lenders that the project can be operated profitably, sometimes assuming limited government support, and that projected revenues will cover all project construction and operating costs, while providing a return to equity investors.

Since the franchisee assumes almost all project risk, it is free to design the project without subjective design approval by the authorizing agency, though it will be required to meet State standards for design, construction, quality and safety.

The franchisee will have the task of obtaining all financing for the project, including all required equity, senior debt and subordinated debt. If tax-exempt financing is involved, the transaction must be structured to satisfy the IRS management contract rules (see Attachment A) and the debt may be issued through a government or nonprofit entity, which will function primarily as a conduit without any other financial obligation to repay the debt. For a discussion of the transaction structure utilizing a nonprofit corporation, popular in recent years, see Attachment B.

The franchisee will then operate the project in accordance with an operating plan subject to limited approvals by the agency. The franchisee will set and collect all user fees for the project, subject only to rate of return or other regulatory or contractual limitations.

B. Suitability

Concessions utilizing limited public financial assistance are most suitable for projects whose revenues will be generally sufficient to cover financing and operating costs, but whose risks during the development period are too great to be born by the private sector alone. Perceived benefits to the government must be strong enough to justify its bearing the costs and risks of obtaining right-of-way, environmental clearances, community acceptance and necessary governmental approvals and permits. This combination of State and private effort, however, can facilitate the building of transportation systems for which sufficient public funds are not available, or would not be available for many years.

Particularly if some public funding will be provided, it is important to secure long-term legislative and gubernatorial commitments and address at an early stage local, project-specific concerns.

IX. PRIVATE CONCESSION TO DESIGN-BUILD-OPERATE PROJECT WITH NO PUBLIC AGENCY SUBSIDY OR OTHER GOVERNMENT FINANCIAL COMMITMENT

A. Public/Private Roles

1. Government Risks and Responsibilities

The agency's oversight role is generally the same as described in Section VIII, but it provides no financial assistance. It may exercise eminent domain powers on behalf of the concessionaire, but the private party must pay the cost of all awards.

2. Private Sector Risks and Responsibilities

Without any financial assistance by the State, all project responsibilities fall on the developer, including obtaining all environmental permits and acquisition of all right-of-way. The State may retain certain liabilities, such as for change in law, force majeure or tort liabilities attributable to State action.

B. Suitability

The fundamental requirement for the success of a private concession without any government financial assistance is that projected revenues solely from project operations must be clearly sufficient to cover all costs of construction and operation (with a suitable cushion) and return equity to

investors at a rate commensurate with the risk. In addition, the length of the development period and amount of money required to be at risk prior to financing must be manageable.

Attachment A

IRS Management Contract Rules

When a management contract is entered into in connection with facilities financed with the proceeds of tax-exempt obligations, the activities performed pursuant to such management contract may cause the interest paid with respect to such obligations to lose its tax-exempt status. Section 141 of the Internal Revenue Code of 1986, as amended (the "Code"), the Treasury Regulations promulgated under Section 141 (the "Regulations") and Revenue Procedure 97-13 provide rules for structuring management contracts which will avoid this undesirable result. The purpose of this memorandum is to describe the terms which must be contained in a management contract that complies with the requirements of the Code, the Regulations and Revenue Procedure 97-13. Any reference below to the "governmental issuer" is intended to include a nonprofit corporation which is acting on behalf of a governmental issuer.

Background

The Code places certain restrictions on the use of the proceeds of tax-exempt obligations. In particular, if the proceeds are used in the trade or business of a private (i.e., nongovernmental) party ("Private Use"), the interest on the obligations may no longer qualify for tax-exemption.

Typically, Private Use occurs when the private party controls the financed facility through outright ownership, or as the result of a long-term lease. In addition, unlimited use by a private party pursuant to a management contract causes the manager to be deemed to be in a joint venture with the governmental issuer, and results in impermissible Private Use.

The Regulations define a management contract as any management, service, or incentive payment contract between a governmental issuer and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility.

The Regulations provide that certain service arrangements will not be treated as management contracts. These include: (1) contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services), and (2) a contract to provide services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

With respect to management contracts, Revenue Procedure 97-13 provides guidelines under which a private party's use of a bond-financed facility pursuant to a management contract will not be treated as a Private Use.

Revenue Procedure 97-13 - Guidance

Revenue Procedure 97-13 describes three permissible structures for conforming management contracts. In each of these structures Revenue Procedure 97-13 places limitations on the following aspects of the management contract: (1) the term of the management contract, and (2) the compensation of the manager.[1] The three structures are described in detail below. However, the following guidelines apply to all three structures.

With respect to the term of the management contract, a renewal option which gives the manager a legally enforceable right to renew the contract is included in determining the term of the contract. A renewal option on the part of the governmental issuer is not included in determining the term of the contract.

With respect to the manager's compensation, the following guidelines are provided:

(1) The compensation must be reasonable for the services provided;

(2) Reimbursement of the manager for actual and direct expenses paid by the manager to unrelated parties is not treated as compensation;

(3) No portion of the compensation may be based on a share of the net profits from the operation of the facility. A portion of the compensation (the "Variable Portion") may be based on a percentage of gross revenues of a facility, or a percentage of expenses from a facility;

(4) In each of the permissible arrangements, a certain portion of the compensation must consist of a periodic fixed fee (the "Fixed Portion"). This must consist of a stated dollar amount for services rendered for a specified period of time. In

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[1] Revenue Procedure 97-13 also provides a limitation on the degree of common control between the governmental issuer and the manager. Specifically, Revenue Procedure 97-13 states that not more than 20% of the voting power of the governing body of the governmental issuer may be vested in the manager and its directors, officers, shareholders and employees.

addition, the stated dollar amount may be adjusted according to a specified, objective, external standard that is not linked to the output or efficiency of the facility, such as the Consumer Price Index.

Revenue Procedure 97-13 – Permissible Arrangements

Utilizing the guidance described above, Revenue Procedure 97-13 describes three permissible management contract structures in which the manager's activities will not constitute "Private Use."

(1) 5-Year Management Contract. The requirements of this structure are as follows:

(A) The term of the management contract (including renewal options by the manager) does not exceed five years;

(B) The Fixed Portion is at least 50% of the compensation to the manager; and

(C) The governmental unit owning the facility may terminate the management contract (without penalty) at the end of any 3-year period.

(2) 10-Year Management Contract. The requirements of this structure are as follows:

(A) The term of the management contract (including renewal options by the manager) does not exceed ten years;

(B) The Fixed Portion is at least 80% of the compensation to the manager; and

(C) The manager may receive a one-time incentive award during the term of the management contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached. The award must consist of a single stated dollar amount.

(3) 15-Year Management Contract. The requirements of this structure are as follows:

(A) The term of the management contract (including renewal options by the manager) does not exceed fifteen years;

(B) The Fixed Portion is at least 95% of the compensation to the manager; and

(C) The manager may receive a one-time incentive award during the term of the management contract under which compensation automatically increases when a gross revenue or expense target (but not both) is reached. The award must consist of a single stated dollar amount.

Conclusion

If the terms of a management contract comply with one of the three permissible structures described above, the manager's activities will not be considered Private Use, and will not cause the interest on the obligations to lose its tax-exempt status.

Attachment B

The Use of "63-20" Nonprofit Corporations in Infrastructure Facility Development

X. Advantages of Nonprofit Corporations in Development of Infrastructure Facilities

The use of nonprofit corporations (sometimes referred to as "63-20 Corporations") in structuring public/private infrastructure financings has recently attracted a great deal of attention. Its use is being promoted as a way to preserve the ability for a project to be financed with tax-exempt bonds, while maintaining for both the public and private participants most of the benefits of private development.

Nonprofit corporations have long been used as a vehicle to finance the construction of public buildings, including hospitals, court houses and schools. Historically, such projects have been accomplished through the use of nonprofit corporations in order to avoid statutory debt limitations and other restrictions. More recently, private developers in association with public agencies around the country have begun to utilize the nonprofit structure to develop major transportation projects, particularly those involving innovative contracting and public-private partnerships. Examples include Virginia's Pocahontas Parkway, South Carolina's Southern Connector, the new Las Vegas Monorail, and the proposed Tacoma Narrows Bridge and California's SR 125 toll road projects.

The advantages of using a nonprofit sponsor to undertake a public/private partnership include, among other things: (a) the ability to create a governing structure that includes representatives from both the public and private sectors; (b) facilitating the transfer to the private sector of significant project risk while preserving the ability to finance the project through the issuance of tax-exempt debt if necessary; (c) insulating public agency sponsors from financial or other liability; (d) giving an affected community more direct control over key decisions and key project aspects; (e) the ability to receive and utilize federal, state and local government grants or loan proceeds; (f) enabling participation by other non-profit organizations; (g) avoiding the need for special legislation to implement a project; and (h) combining the relative strengths of the public sector with the private sector's value added efficiency and innovation in ideas.

XI. Basic Characteristics

A nonprofit corporation is a private, nonstock corporation that may be formed under the nonprofit corporation act of a state. The formation does not require special legislation, nor does it require a referendum in the local or sponsoring jurisdiction. A nonprofit corporation may be formed for any lawful purpose other than for pecuniary

profit, including, without limitation, any charitable, benevolent, educational, civic, or scientific purpose. No dividends are paid and no part of the income or profit of a nonprofit corporation may be distributed to its members, trustees or officers. Nonprofit corporations are regulated by the State Attorney General for compliance with the nonprofit corporation act, by state tax authorities for compliance with the requirements relating to their state income tax exemption and by the Internal Revenue Service for compliance with the requirements relating to their federal income tax exemption, and the issuance of tax-exempt debt.

When public agency members authorize the formation of a nonprofit corporation, such members can restrict the purposes or powers of the nonprofit in its certificate of incorporation. The corporation may have members, and each member may be given the right to appoint one or more trustees. The provisions of these articles of incorporation and the bylaws of the corporation may not be amended without the approval of the board of trustees.

XII. Formation Of A Nonprofit Corporation

A nonprofit corporation is formed in the same manner as business corporation. One or more individuals, corporations or corporate entities may act as incorporators of a nonprofit corporation by executing and filing in the office of the Secretary of State a certificate of incorporation. The completion of the organization of the corporation includes the adoption of bylaws and the appointment of trustees and officers. The method of electing or appointing trustees may be set out in the certificate of incorporation or in the bylaws, and may include election or appointment by members or classes of members or by the board itself.

The initial bylaws of a nonprofit corporation are adopted by the board at its organizational meeting. Thereafter, the board has the power to make, alter and repeal bylaws unless that power is reserved to the members (if the corporation has members) in the certificate of incorporation or the bylaws. The members may prescribe in the bylaws that any bylaw made by them shall not be altered or repealed by the board.

XIII. Governance Of A Nonprofit

Individual members of the board of trustees may be appointed by members as provided in the Bylaws of the corporation. It is also possible to include private sector representatives on the board, including directors designated by major contracting entities, chamber of commerce and other stakeholders. Thus, members on the board of a nonprofit could be designated by local mayors or city councils, regional or state agencies as appropriate.

Members of the board may serve with or without compensation, but in all events may be reimbursed for reasonable expenses. Directors and officers can also be indemnified by the corporation against third party claims as long as their individual acts were not in breach of duty of loyalty to the corporation, not in good faith or involve a knowing violation of law or the receipt of an improper personal benefit.

Members of a nonprofit corporation are usually, by statute, immune from personal liability for the debts, liabilities or obligations of the corporation.

XIV. Powers And Operations Of A Nonprofit Corporation

A nonprofit corporation may have broad powers to undertake activities related to its purpose, including (1) the power to sue and be sued, (2) to take and hold by lease, gift, purchase or grant any real or personal property necessary or desirable for carrying out the purposes of the corporation and to purchase, lease or otherwise acquire, own, use and otherwise deal in real or personal property, (3) to sell, covey, mortgage, create a security interest in, lease, exchange, transfer and otherwise dispose of its property and assets, (4) make contracts and guarantees and incur liabilities, borrow money, issue bonds and secure any of its obligations by mortgage or security interest in its property, franchises and income, and (5) participate with others in any corporate entity, partnership, limited partnership, joint venture, or other association, or in any transaction or arrangement which the participating corporation would have power to conduct by itself, and (6) have an exercise all other powers necessary to convenient to effect any of the purposes for which the corporation is organized.

An nonprofit would thus have the power to:

- acquire a project site and develop it through contracts with private contractors for the design and construction of the project facilities;
- enter into agreements with public and/or private entities for financing of the facilities; and
- enter into agreements with third parties for operation or use of the project facilities.

XV. Financing Of The Project; Issuance Of Tax-Exempt Debt

The use of a nonprofit project sponsor could facilitate the qualification of the project to receive public funds since the revenues of the project will not inure to any private party. It may also be possible for the nonprofit to issue public or privately-placed debt if the nonprofit can enter into fixed and certain, long-term contracts for the use of the facility.

Such debt may be issued on a tax-exempt basis, which would result in significant savings in financing costs to the project. Notwithstanding the fact that the nonprofit corporation is a private corporation, it may qualify to issue tax-exempt debt if it satisfies certain IRS requirements, including those set forth in Rev. Rul. 63-20 and Rev. Proc. 82-26, as follows:

a) The corporation must engage in activities which are essentially "public in nature."

b) It must be not organized for profit.

c) The corporate income must not inure to any private person.

d) The State or political subdivision must have a "beneficial interest" in the corporation while the indebtedness remains outstanding.

e) The corporation must be approved by the State or the political subdivision, which must also approve the specific obligations issued by the corporation.

f) Unencumbered legal title in the financed facilities must vest in the governmental unit after the bonds are paid.

The rules for determining whether the governmental unit has the requisite "beneficial interest" in the nonprofit corporation are likewise quite straightforward.

a) The governmental unit must have exclusive beneficial possession and use of at least 95% of the fair market value of the facilities; *or*

b) If the nonprofit corporation has exclusive beneficial use and possession of 95% of the fair market value of the facilities, the governmental unit appoints 80% of the members of the board of the corporation and has the power to remove and replace members of the board; *or*

c) The governmental unit has the right at any time to get unencumbered title and exclusive possession of the financed facility by defeasing (paying off or providing for payment of) the bonds.

XVI. Contractual Arrangements

In a project financed through a "63-20" nonprofit corporation, the non-profit corporation, rather than the private developer, will generally be the nominal owner and operator of the project. It is the party that will, from inception or by assignment, own the franchise or other development rights to develop the project; it may be the contracting party with respect to the design, construction and supply contracts; and it will almost always be the party that contracts for maintenance and operations.

The key agreements will be as follows:

Franchise or Development Agreement

Under most State privatization laws, the franchise or development agreement is the central contract under which the State or local transportation agency will grant to a private party rights to develop the toll road, rail line or other transportation project. The franchise may be awarded in response to an RFP from the government agency or as a result of negotiations with respect to an unsolicited proposal.

The parties to the franchise agreement can be (i) the governmental unit (the "Agency") and the private project proposer (the "Developer") or (ii) the Agency and the nonprofit corporation. If the Developer is the initial franchisee, it will usually assign the franchise or development agreement to the nonprofit corporation prior to closing the financing.

The franchise or development agreement will typically address the following issues, among others:

- geographic extent of development rights
- protection from competitive facilities
- standards for design, construction, operation and maintenance
- contract requirements
- right of way acquisition
- flow of funds
- interoperability
- bonding, insurance and indemnification
- defaults, remedies and termination, and
- lenders rights.

Project Development Agreement

The Project Development Agreement, sometimes called a Management Agreement, is the agreement between the nonprofit corporation and the Developer. This entity is sometimes structured as a limited liability company owned by the design and construction firms interested in building and/or operating the project.

Under the Project Development Agreement, a private Project Manager may act as the agent of the nonprofit corporation to negotiate and oversee the design and construction contracts (usually a design-build contract) as well as the operating and maintenance contracts. This is also the entity that will be responsible for all pre-closing tasks, such as permitting and preliminary design.

Design-Build Agreement

If the project is to be built under a design-build procurement, this contract may be entered into between the nonprofit corporation and the entity or joint venture undertaking both design and construction responsibilities. Design-build arrangements can enhance the financing because of their fixed price and completion date guarantees. (Affiliations between the Developer/Project Manger and the Design-Build team can raise conflict of interest questions that have to be appropriately analyzed, especially when the private parties have no equity at risk in the project.)

Operations and Maintenance Agreements

For tollroad projects, a toll operations agreement will be between the nonprofit corporation and a private toll operating entity, which may or may not have responsibility for maintenance of the roadway as well. These contracts must be structured to comply with the IRS "management contract" rules which restrict the term of the agreement and the ability to award incentive compensation. In some projects, the transportation agency may assume some or all maintenance responsibilities.

For a rail or transit project, the nonprofit corporation would enter into an operating contract with a private operating company. Long-term maintenance could also be part of the design-build contract.

Trust Indenture and Financing Agreements

The nonprofit corporation will issue the project debt pursuant to a trust indenture between the corporation and a trustee for the bondholders. (No other tax-exempt issuer need be involved, since the "63-20" nonprofit itself issues the debt "on behalf of" the governmental unit.) If the government is making a financial contribution or loaning any money into the project, there may also be a separate financing agreement with the Agency or a state infrastructure bank. Contractors or other private entities providing subordinated debt may also be a party the Financing Agreement.

The Trust Indenture will contain rate covenants for protection of bondholders. Either the Trust Indenture or the Financing Agreement will also contain conditions to disbursement of bond proceeds.

The trustee may or may not have a security interest in real or personal property associated with the project. The lender's basic security will be the rights of the nonprofit corporation to operate the project and collect toll revenues or fares for the franchise period under the franchise agreement.

XVII. Issues For Governmental Unit: Control V. Liability

In a "63-20" project, the Agency may face a dilemma. If the Agency wants the nonprofit corporation to perform as its true "alter ego," it may want to take steps to insure it has the ability to exercise direct control. It could do this through reserving the right to appoint directors, or requiring Agency representation on the board. Doing so, however, may subject the Agency to legal or political liability in the event the project incurs financial difficulties. As a result, many public agencies elect to minimize their formal involvement with the nonprofit corporation, treating the nonprofit corporation as if it were a private party.

Nevertheless, the Agency may desire to exercise the same degree of control over the private parties as it would were there not this intervening entity. Typically this is done by giving the Agency rights under the franchise agreement with respect to approval of contracts and subcontracts entered into by the nonprofit corporation. How strong the approval rights are may depend largely on whether the Agency or the state infrastructure bank is making its own financial contribution to the

project. In addition, the Agency may require the nonprofit corporation and its contractors to meet various conditions prior to commencement of construction or acceptance of the facility upon completion. The Agency will also want detailed reporting during both construction and operations.

XVIII. Issue For Developer: Protecting Rights To Manage Development And Construction

Typically the Developer will play the lead role in negotiating all the project agreements, without much substantive participation by the nonprofit corporation. The Developer will generally seek very broad authority *vis a vis* the nonprofit corporation to manage development, construction and operation under the Management Agreement. The Agency, on the other had, is going to want to ensure that all the substantive responsibilities of the nonprofit corporation under the franchise agreement are backed by obligations of the private contracting parties under the Management Agreement, the Design-Build Contract and the Operating and Maintenance Agreements, including provision of performance bonds and guarantees.

XIX. Issues For Nonprofit: Avoiding Personal Liability

The initial primary concern of the nonprofit corporation is avoiding liability, particularly personal liability of its board members. They may try to obtain broad indemnification from both the Agency and the private parties. Officers and director's insurance is advisable, but sometimes difficult to get for a start-up entity. The nonprofit corporation should be represented by separate counsel, which may be the bond counsel responsible for drafting the trust indenture. The nonprofit corporation will also need some source of financial support for any pre-closing costs that are not contingent. This can come from the private entities or from the Agency.

Over the long-term, this entity will need some staffing. In some transactions, this can be provided by the Agency, which can give the Agency no small measure of practical control over the affairs of the nonprofit corporation. Alternatively, its duties will be carried out through the Developer/Project Manager, acting as its agent under the Management Agreement.

XX. Conclusion

To insure the long-term success of a 63-20 financing, the role of the nonprofit corporation must be properly understood by all the parties, including the private project sponsors as well as the authorizing governmental agency. Unlike certain prior uses of "63-20" corporations to facilitate public financings, in a public/private venture, the nonprofit corporation will not just be a passive financing conduit. It will have long-term construction and operating responsibilities.

The fact that it is not formally under the control of either the governmental unit or any private party, means that all of the parties need to pay strict attention to their contractual rights under all the project documents. And further, since in a tax-exempt

transaction, the private party has no long term equity interest in the project to protect, it is important that the project contracts grant the public agency participant an appropriate measure of supervision and control throughout the life of the project.